JULY 2005 | NO. 26

The PERAC Financial Bulletin

Financial Market Review, Second Quarter 2005

By some measures, stock valuations are attractive, but the market has faced some stiff headwinds that have stalled any sustained advance through the first half of 2005.

Economic expansion and job growth have both been solid but unspectacular, and future growth could be negatively impacted if oil prices remain at their recent record-high levels. Perhaps the biggest uncertainty was if and when the Federal Reserve would curtail its program of raising short-term interest rates. The Fed's June 30 statement did not offer any encouragement that an end to its tightening was at hand. Worries about war and terrorism have lurked beneath the surface but came into closer view after the July 7 train bombings in London.

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Q2

Stocks eked out modestly positive returns and the bond market continued to perform better than expected, but the major financial markets still finished the first half of 2005 with generally uninspiring performance.

EQUITY MARKET

Stocks tried to do better during the second quarter on hopes that the Federal Reserve's tightening was nearing an end, but the market gave back some of its gains during the final weeks under the weight of oil prices spurting to $60 a barrel and worries over slowing economic expansion, declining profit growth, and indications from the Fed at quarter-end that it would likely continue to raise short-term rates.

Nearly all major stock indices were up modestly for the second quarter but were, on average, mostly flat (zero) for the first six months of 2005. The market's broadest index, the Dow Jones Wilshire 5000, was up 2.47% for the quarter but up only 0.02% for the year to date. Reprising a long-term trend that many thought would decisively reverse by now, small caps (Russell 2000) outperformed large caps (S&P 500) during the second quarter although large caps have done slightly better year to date. Among styles, differentials in performance between value and growth have not been significant so far this year. With a 2.9% return, the technology-laden NASDAQ Composite rebounded from a weak first quarter but is still down -5.45% for the year. Over the trailing five years through June 30, the Russell 2000 has had an annualized return of 5.71%, versus -2.37% for the S&P 500, and, within the S&P 500 universe, value has outperformed growth by over 11% annualized.

Of the S&P 500's ten industrial sectors, only three are up year to date: Energy (+18.84%), Utilities (+13.16%), and Health Care (+2.69%), while the other seven have had negative returns, with Materials (-8.83%) being the laggard. Among notable stocks, Boeing (+27.5%) and Exxon Mobil (+12.1%) led the gainers while General Motors (-15.1%) and IBM (-24.7%) have been among the worst performers so far this year.

Overseas, many stock markets outperformed the US. Spurred by attractive valuations, very low interest rates, and the results of corporate restructuring, European markets have done particularly well, up about 10% so far this year in local currency terms. Japan's stock market has been weak as exports have slowed and oil prices have taken their toll. Nevertheless, US investors' returns from foreign stocks have been negatively impacted

Chart 1

S&P 500: 2005 To Date

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by the effect of the stronger dollar, which had its best overall quarterly performance in the currency markets in over four years. The dollar has recovered more than 12% versus the Euro this year. Accordingly, while the MSCI-EAFE Index was up 4.55% and 8.07% in local currency terms for the second quarter and year-to-date, respectively, translated returns were actually negative, showing -1.01% and -1.17%, respectively, in dollar terms. US investors enjoyed much better returns from emerging markets, where local currencies basically held their own versus the dollar.

FIXED INCOME MARKET

The bond market exhibited resilience in the face of challenges and volatility. The Fed increased the Federal funds rate twice more, to 3.25%. About $85 billion of bonds issued by General Motors and Ford dropped into junk bond territory after simultaneous downgrades by Standard & Poor's. Nevertheless, bonds generally produced modestly positive returns for the quarter as well as year-to-date. The Lehman Brothers Aggregate Index was up 3.0% for the quarter and 2.5% year-to-date. Despite the Fed's actions, yields on the benchmark 10-year Treasury note actually declined during the quarter from 4.50% to 3.92%. Even more surprising, the ten-year note yielded 4.69%—77 basis points higher than on June 30, 2005—on the day in June 2004

Chart 2

S&P 500: A Five-Year Perspective

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Chart 3

S&P 500: A Ten-Year Perspective

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Chart 4

S&P 500 vs. Russell 2000:

Over Five Years, Small Caps Rule

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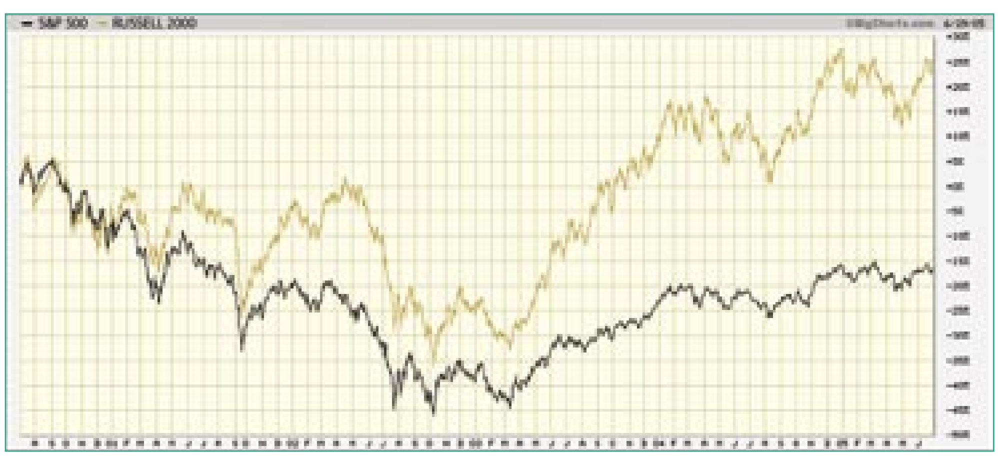

when the Fed initiated its tightening moves, which have so far resulted in a 2.25% rise in short-term rates. After the initial shock, the corporate and high-yield "junk" bond markets stabilized within days of the downgrade of the major automakers' debt.

The strength in the longer maturity bonds in the face of rising short-term rates has resulted in an unusually flat yield curve, where the ten-year Treasury note yield was only 31 basis points higher than that of the 2-year note at month end. While even Fed Chairman Greenspan referred to the bond market's strength as a "conundrum" earlier this year, the situation basically reflects investors' confidence that inflation will remain restrained over the coming years. Other contributing factors might be purchases by pension funds seeking to "immunize" their liabilities and purchases by foreign (largely Asian) central banks that have accumulated dollar-denominated assets.

While some bond managers are saying that the time has come to adjust to a period of historically low interest rates, others fretted about how long these rates could remain low given the likelihood of further Fed tightening after the central bank's statement of June 30 that "pressures on inflation remain elevated". Others worried that, in past cycles, the Fed has tended to raise rates until some type of financial accident or economic shock has occurred

OTHER ASSET CLASSES

During this period of lackluster returns from the equity and fixed income markets, investors have been increasingly looking to other asset classes for performance and the asset class with the most "buzz" has clearly been real estate. Indeed, some analysts have predicted that the increasingly robust real estate market is a bubble waiting to burst. In any case, real estate investment trusts rose by over 14% during the quarter and are up 6.4% for the year. Over the past five years, the annualized return from equity REITs has been 20.5%, compared to -2.4% for the S&P 500 Index. According to the NCREIF National Property Index, private real estate (consisting of apartments, industrial, office, and retail) appreciated by 14.4% in 2004 and was rising at a similar rate through the first quarter of this year.

The directionless equity market has taken its toll on the market for initial public offerings so far this year. Total issuance was down from the same quarter in 2004 and many of the offerings that did come to market had to be reduced in size and/or price. Returns from venture capital and other forms of private equity are significantly lagged but are likely to show mixed results. After a strong year in 2004, annualized returns from all private equity (venture capital, buyouts, and mezzanine) exceeded those of the S&P 500 by 2-5% over 3, 5, and 10 year periods.

Investors seeking superior returns from stocks and bonds have not found them from hedge funds so far this year. Rumors of large hedge funds suffering sizeable losses in the wake of the GM/Ford downgrades proved to be exaggerated, but there are increased concerns over the continuation of low returns from these high-fee products. Through June, most hedge fund composites showed basically flat (zero) returns, while convertible arbitrage, one of the most popular strategies of recent years, suffered composite losses of about 8%. The industry's problems were attributed to the directionless trend and low volatility of the financial markets and the

Chart 5

Interest Rates: Still Historically Low

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fact that an increasingly large sum of hedge fund money has been chasing after a diminishing number of trading opportunities. While there have been no major blow-ups, some large hedge funds have elected to shut down their operations (returning funds to their investors) and there were indications that the rush of new money into hedge funds has begun to slow.

OUTLOOK

Although the markets' initial reaction was encouraging, the July 7 terrorist bombings in London added another factor of uncertainty to an already muddled investment outlook. As we have said before, there are no "magic bullet" solutions to cope with a period of below-average returns. As retirement boards with healthy allocations to small caps, value stocks, international stocks, and real estate have realized over the past five years, there are significant benefits over time to having exposure to as many asset classes and subclasses as possible. Also, there should be very little tolerance of active investment managers who consistently fail to meet if not beat their benchmarks. In terms of regulation, PERAC will objectively examine and carefully consider any new or different strategies or asset classes that may be of interest to retirement boards.

Chart 6

The Yield Curve Has Flattened Significantly

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Chart 7

Quality Yield Spreads Have Widened Modestly

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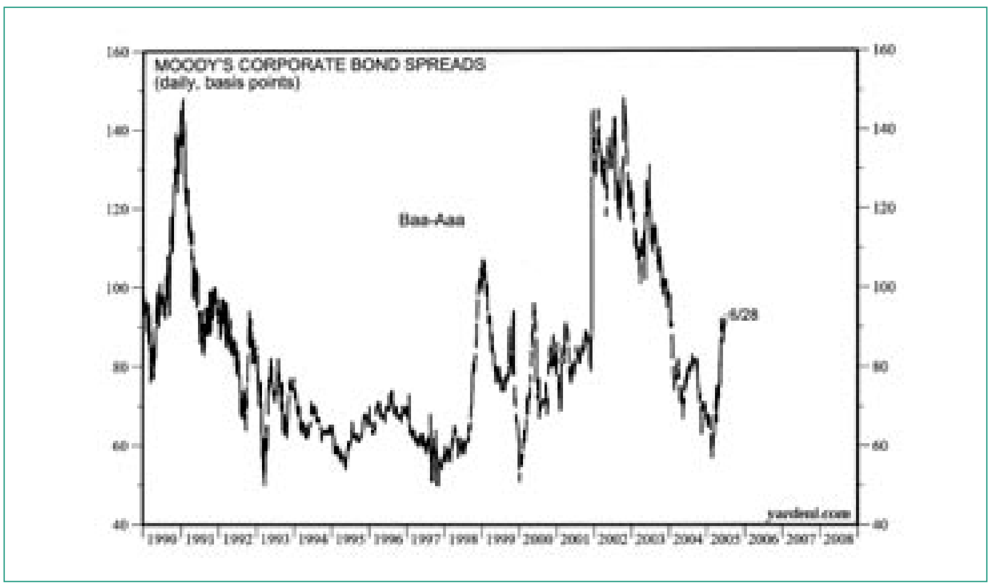

TOTAL RETURNS | SECOND QUARTER, 2005

INDEX	SECOND QUARTER 2005	SIX MONTHS 2005
US EQUITY MARKET		
Dow Jones Industrial Avg.	- 1.62%	- 3.65%
Standard & Poor's 500 (Large Cap)	+ 1.37%	- 0.81%
NASDAQ Composite	+ 2.90%	- 5.45%
Wilshire 5000 (Broad Market)	+ 2.47%	+ 0.02%
Standard & Poor's Mid-Cap 400	+ 4.26%	+ 3.85%
Russell 2000 (Small Cap.)	+ 4.32%	- 1.25%
GROWTH VS. VALUE		
S&P 500 Growth	+ 0.14%	- 1.73%
S&P 500 Value	+ 2.58%	+ 0.09%
S&P Midcap 400 Growth	+ 3.66%	+ 3.57%
S&P Midcap 400 Value	+ 4.86%	+ 4.12%
Russell 2000 Growth	+ 3.48%	- 3.58%
Russell 2000 Value	+ 5.08%	+ 0.90%
INTERNATIONAL EQUITY		
M.S.C.I. - E.A.F.E.	- 1.01%	- 1.17%
M.S.C.I. - Emerging Markets	+ 4.13%	+ 6.00%
FIXED INCOME		
Lehman Brothers Aggregate Index	+ 3.01%	+ 2.52%
Merrill Lynch High Yield Index	+ 2.61%	+ 1.13%
REAL ESTATE		
NAREIT - Equity Real Estate Investment Trusts	+ 14.45%	+ 6.38%
NCREIF Property Index	+ 3.51% (Q1)	+ 8.33% (Trailing 6 months)

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